May 15, 2006

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: February 23, 2006
Proposed Rules: Supervisory Committee Audits
12 CFR Parts 704, 715, and 741

Dear Ms. Rupp:

The American Institute of Certified Public Accountants (AICPA) Depository Institutions Expert Panel (DIEP) appreciates the opportunity to provide input concerning the National Credit Union Administration's (NCUA) advanced notice of proposed rulemaking (ANPR) to amend part 715 of the NCUA rules and regulations. The AICPA commends the NCUA on its project to reexamine and improve these rules and regulations.

The AICPA is the largest professional association of certified public accountants in the United States, with more than 330,000 members in business, industry, public practice, government, and education.

Because depository institutions engage in similar depository and lending activities, the DIEP believes that depository institutions should be subject to similar accounting, auditing, and regulatory requirements. This is consistent with the view taken by the Accounting Standards Executive Committee (AcSEC) in Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, and that was later expressed in the AICPA's combined Audit and Accounting Guide, *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies.* SOP 01-6 eliminated prior differences in the accounting and financial reporting provisions previously established in the following separate AICPA Audit and Accounting Guides; *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies.* In paragraph 1 of SOP 01-6, the AcSEC took the following position:

> .01 Most lending and deposit-taking transactions are similar and should be accounted for similarly. Prior to this Statement of Position (SOP), certain differences in accounting for similar transactions existed among banks, savings institutions, credit unions, and finance companies (including entities with trade receivables). That banks, savings institutions, credit unions, and finance companies are organized differently is less relevant to the accounting and financial reporting of underlying transactions than that each primarily extends credit or takes deposits (or both).

The underlying belief that standards and regulations should be similar among similar depository and lending organizations forms the basis for many of our responses to the following questions.

A. Internal Control Assessment and Attestation

1. Should part 715 require, in addition to a financial statement audit, an ''attestation on internal controls'' over financial reporting above a certain minimum asset size threshold? Explain why or why not.

We believe that the decision as to whether or not to require an attestation on internal control should be based on whether the benefits to the NCUA and other stakeholders outweigh the cost. Although there

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are additional costs associated with an attestation on internal control, we believe the benefits from such an engagement would be significant to the NCUA.

If the NCUA determines that the benefits outweigh the cost, then we believe Part 715 should require an attestation on internal control over financial reporting only for credit unions meeting a certain minimum asset size threshold. We believe that the NCUA will find that for smaller credit unions, the economy of scales are such that the cost of requiring an attestation on internal control becomes a disproportionate cost compared to credit union size and that the cost will exceed the benefit.

2. What minimum asset size threshold would be appropriate for requiring, in addition to a financial statement audit, an ''attestation on internal controls'' over financial reporting, given the additional burden on management and its external auditor? Explain the reasons for the threshold you favor.

If the NCUA chooses to apply the attestation on internal controls to credit unions, we believe there should be a minimum asset size threshold. While we believe the selection of the threshold is best left to the NCUA, we offer the following observations:

FDIC-insured institutions with assets of $1 billion or more must have an examination of internal control. This asset threshold provides approximately 85% of coverage of total FDIC insured assets. Currently, both credit unions and FDIC-insured institutions with assets of $500 million or more must undergo an audit of their financial statements. Although the FDIC recently raised its threshold to $1 billion in assets, FDIC-insured institutions with assets of $500 million or more have demonstrated that they are capable of undergoing an examination of internal control.

As an alternative, the NCUA could consider having management assess and make public its assertion as to the effectiveness of its internal control over financial reporting, without auditor attestation. As part of every audit, the auditor is required to communicate to management and those charged with governance (typically the Supervisory Committee), internal control deficiencies, which based on the auditor's assessment, constitute material weaknesses or significant deficiencies. Those charged with governance would then have the responsibility to reconcile any auditor communication with management's assessment and its assertion as to the effectiveness of the entity's internal control.

As a means of easing the transition from existing regulations to required examinations of internal control, the NCUA may wish to consider another alternative, a provision in the AICPA's proposed Statement on Standards for Attestation Engagements (SSAE), *Reporting on an Entity's Internal Control Over Financial Reporting*, (AT 501) that permits practitioners to report on only the *design* effectiveness of an entity's internal control. Design effectiveness refers to whether controls are capable of effectively preventing or detecting and correcting material misstatements; whereas operating effectiveness focuses on how controls are applied, the consistency with which they are applied, and by whom they are applied. An examination covering only design effectiveness would be less costly than an examination covering both design *and* operating effectiveness, and therefore may be an alternative worth considering for smaller credit unions.

3. Should the minimum asset size threshold for requiring an ''attestation on internal controls'' over financial reporting be the same for natural person credit unions and corporate credit unions? Explain why.

Yes, we believe that the asset size threshold for examinations of internal control should be the same for natural person credit unions and corporate credit unions. Corporate credit union members consist of natural person credit unions, and both types of credit unions have similar operations, face similar risks, are insured by the NCUSIF, and ultimately serve the same public interest.

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4. Should management's assessments of the effectiveness of internal controls and the attestation by its external auditor cover all financial reporting, (*i.e.*, financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes), or should it be more narrowly framed to cover only certain types of financial reporting? If so, which types?

Management's assessment of internal control over financial reporting should cover all financial reporting. Insured depository institutions subject to the internal control reporting requirements of Section 36 of FDICIA and its implementing regulation must include in their assertion about internal control, at a minimum, controls over financial reporting. However, the term *financial reporting* is not defined in Section 36 of the FDI Act, Part 363. Accordingly, the FDIC clarified in Financial Institution Letter (FIL) 86-94, *Additional Guidance Concerning Annual Audits, and Reporting Requirements,* that financial reporting should include financial statements prepared for regulatory reporting purposes. The FIL states:

> Section 36(b)(2) of the FDI Act requires an institution's management to state its responsibility for establishing and maintaining an adequate internal control structure and procedures for "financial reporting." Management must also report on the effectiveness of this internal control system and its independent public accountant must attest to management's assertions. The term "financial reporting' is not defined in Section 36 of the FDI Act or Part 363. As a result, the guidelines to Part 363 indicate that professional accounting and auditing literature should be consulted. That literature refers to "financial reporting" in terms of published financial statements prepared on a comprehensive basis of accounting. Based on this definition, the term "financial reporting," at a minimum, includes financial statements prepared under generally accepted accounting principles (GAAP) and those prepared for regulatory reporting purposes.

For parity, we believe that the NCUA guidance also should address financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes. We further observe that the AICPA's proposed Statement on Standards for Attestation Engagements (SSAE), *Reporting on an Entity's Internal Control Over Financial Reporting*, provides reporting guidance for situations in which the scope of the controls covered by management's assertion about internal control extends beyond controls over financial reporting.

5. Should the same auditor be permitted to perform both the financial statement audit and the ''attestation on internal controls'' over financial reporting, or should a credit union be allowed to engage one auditor to perform the financial statement audit and another to perform the ''attestation on internal controls?'' Explain the reasons for your answer.

Part 363.3 of the FDICIA implementing regulations requires the same CPA to perform both engagements. Although an examination of an entity's internal control and an audit of an entity's financial statements generally are performed by the same CPA, the AICPA's proposed SSAE allows different CPAs to perform each engagement. If the two engagements are performed by different practitioners, the practitioner performing the examination of internal control must coordinate the performance of that engagement with the audit of the financial statements. In addition, the two engagements must cover the same period or be as of the same date, as would be the case if the same CPA performed both engagements. Although we concur with the AICPA's proposal, the NCUA could mandate that the same practitioner perform both engagements, consistent with the FDIC rule.

6. If an ''attestation on internal controls'' were required of credit unions, should it be required annually or less frequently? Why?

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An examination of a credit union's internal control should be required annually. If examinations of internal control were performed less frequently, it would be more difficult to identify changes in the credit union's internal control, and would also increase the probability that significant deficiencies and material weaknesses in internal control that could affect the credit union's financial statements would not be identified and communicated to the credit union's management, on a timely basis.

7. If an ''attestation on internal controls'' were required of credit unions, when should the requirement become effective (i.e., in the fiscal period beginning after December 15 of what year)?

It is expected that the AICPA's proposed SSAE will be effective for subject matter or assertions as of, or for a period ending on or after December 15, 2006. In general, we believe that it takes at least 12 to 18 months for an entity to prepare for an examination of internal control. Accordingly, we believe that the effective date for the proposed Rule should be 12 to 18 months after the issuance date of a final rule. As noted in our response to question 2, the AICPA's proposed SSAE allows and provides reporting guidance for examinations of only the design effectiveness of an entity's internal control. The NCUA could permit credit unions with an asset size below a specified threshold to initially undergo an engagement covering only the design effectiveness of internal control, and later undergo an engagement encompassing design and operating effectiveness.

B. Standards Governing Internal Control Assessments and Attestations

8. If credit unions were required to obtain an ''attestation on internal controls,'' should part 715 require that those attestations, whether for a natural person or corporate credit union, adhere to the PCAOB's AS 2 standard that applies to public companies, or to the AICPA's revised AT 501 standard that applies to non-public companies? Please explain your preference.

As noted in our response to question 2, we believe that the AICPA's revised draft of AT 501, because of its flexibility, would be better suited to smaller credit unions since it contains the option of reporting on only the design effectiveness of an entity's internal control. It should be noted that if a credit union opts to undergo an audit of internal control in accordance with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Performed in Conjunction with an Audit of Financial Statements* (AS2), the audit of the financial statements also must be performed in accordance with PCAOB standards because an audit of financial statements and an audit of internal control are both part of an integrated audit. In addition, the practitioner would be subject to all the applicable PCAOB auditing standards (for example, auditing, quality control, and independence requirements) and, because the credit union is a nonissuer, would also be required to comply with the AICPA's auditing, quality control, and ethics standards.

9. Should NCUA mandate COSO's Internal Control—Integrated Framework as the standard all credit union management must follow when establishing, maintaining and assessing the effectiveness of the internal control structure and procedures, or should each credit union have the option to choose its own standard?

Yes, we believe that the NCUA should designate the COSO's Internal Control—Integrated Framework as the criteria that credit union management must follow and the criteria against which internal control must be evaluated. Criteria are the standards or benchmarks used to measure subject matter (in this case, the subject matter is internal control over financial reporting) and against which a practitioner evaluates subject matter. Suitable criteria for evaluating an entity's internal control must have each of the following attributes:

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- Objectivity—Criteria should be free from bias.
- Measurability—Criteria should permit reasonably consistent measurements, qualitative or quantitative, of subject matter.
- Completeness—Criteria should be sufficiently complete so that those relevant factors that would alter a conclusion about subject matter are not omitted.
- Relevance—Criteria should be relevant to the subject matter.

The COSO framework provides suitable criteria for evaluating a credit union's internal control, and the proposed revision of AT 501 is based on the COSO framework. Other suitable criteria may be used in an examination of internal control. In October 2005, the COSO released for public comment an exposure draft titled *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* which is a supplement to COSO's Internal Control — Integrated Framework that focuses on the needs of smaller public companies and their compliance with Section 404 of the Sarbanes-Oxley Act. The guidance identifies how smaller businesses can achieve effective internal control in a more cost-efficient and practical manner.

If the NCUA were to permit the use of other frameworks, then we believe the NCUA should require that these frameworks have the same or similar elements as the COSO framework.

C. Qualifications of Supervisory Committee Members

10. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be required to have a minimum level of experience or expertise in credit union, banking or other financial matters? If so, what criteria should they be required to meet and what should the minimum asset size threshold be?

With regard to this question, we point to existing practices.

SEC issuers are required to disclose whether they have a financial expert on their audit committees, and if they do not, to explain why.

The FDIC, in §363.5, *Audit committees*, requires the following:

> (b) Committees of large institutions. The audit committee of any insured depository institution that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution. If a large institution is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this rule, the holding company audit committee shall not include any members who are large customers of the subsidiary institution.

Currently, there is no similar requirement for smaller FDIC regulated entities or for any NCUA regulated entities.

11. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be required to have access to their own outside counsel? If so, at what minimum asset size threshold?

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No response to question 11.

12. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be prohibited from being associated with any large customer of the credit union other than its sponsor? If so, at what minimum asset size threshold?

No response to question 12.

13. If any of the qualifications addressed in questions 10, 11 and 12 above were required of Supervisory Committee members, would credit unions have difficulty in recruiting and retaining competent individuals to serve in sufficient numbers? If so, describe the obstacles associated with each qualification.

See our response to question 10.

D. Independence of State-Licensed, Compensated Auditors

14. Should a State-licensed, compensated auditor who performs a financial statement audit and/or ''internal control attestation'' be required to meet just the AICPA's ''independence'' standards, or should they be required to also meet SEC's ''independence'' requirements and interpretations? If not both, why not?

FDICIA requires an auditor of FDIC-insured financial institutions with assets in excess of $500 million to be in compliance with the independence requirements in the AICPA's *Code of Professional Conduct* and also to meet the independence requirements and interpretations of the SEC and its staff. Consistent with FDIC requirements, we believe that auditors of the financial statements of credit unions also should be required to meet both sets of standards. The NCUA should note that the SEC independence rules (Rule 2-01 of Regulation S-X, Article 2) include rules related to conflicts of interest resulting from employment relationships, scope of services provided by auditors, partner rotation, audit committee administration of the engagement, and compensation.

15. Is there value in retaining the ''balance sheet audit'' in existing § 715.7(a) as an audit option for credit unions with less than $500 million in assets?

No, we do not believe that the difference in the cost of obtaining an audit of a credit union's financial statements and a balance sheet audit is significant enough to warrant retention of the balance sheet audit. We further believe that a balance sheet audit may provide an unwarranted level of comfort to report users due to the fact that a good portion of the financial statements are not covered by that engagement.

16. Is there value in retaining the ''Supervisory Committee Guide audit'' in existing § 715.7(c) as an audit option for credit unions with less than $500 million in assets?

We believe that Supervisory Committee Guide audits should be retained as an option. We also recommend that the NCUA consider the guidelines in the "Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations" issued by the Federal Financial Institutions Examination Council (FFIEC). That Statement encourages banks and savings associations that have less than $500 million in total assets and are not subject to other audit requirements to adopt an external auditing program as a part of their overall risk management process. The policy statement recognizes that a full scope audit may not be feasible for every small bank and in such cases, encourages those banks to pursue appropriate alternatives to a full scope audit that are set forth in the policy statement.

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17. Should part 715 require credit unions that obtain a financial statement audit and/or an ''attestation on internal controls'' (whether as required or voluntarily) to forward a copy of the auditor's report to NCUA? If so, how soon after the audit period-end? If not, why not?

Yes, credit unions that obtain a financial statement audit or examination of internal control should be required to forward a copy of the auditor's report to the NCUA. FDICIA requires the report to be forwarded to the FDIC within 90 days after the end of the period being audited. However, for cost savings, the NCUA may wish to adhere to the existing requirement of 120 days.

18. Should part 715 require credit unions to provide NCUA with a copy of any management letter, qualification, or other report issued by its external auditor in connection with services provided to the credit union? If so, how soon after the credit union receives it? If not, why not?

Generally accepted auditing standards require the auditor to make certain communications to those charged with governance, typically the Supervisory Committee. Those communications are made pursuant to Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit* and SAS 61 *Communication with Audit Committees* (the AICPA's Auditing Standards Board is in the process of amending both of these standards). To the extent these required communications are made in writing, we would not object to them being shared with the NCUA

19. If credit unions were required to forward external auditors' reports to NCUA, should part 715 require the auditor to review those reports with the Supervisory Committee before forwarding them to NCUA?

As noted above, required auditor communications are addressed to and discussed with those charged with governance, typically the Supervisory Committee. Therefore, the auditor would have discussed these matters with the Supervisory Committee before the credit union forwarded them to the NCUA.

20. Existing part 715 requires a credit union's engagement letter to prescribe a target date of 120 days after the audit period-end for delivery of the audit report. Should this period be extended or shortened? What sanctions should be imposed against a credit union that fails to include the target delivery date within its engagement letter?

We believe that 120 days is a reasonable amount of time. FDICIA does not require inclusion of a target date in the engagement letter. The NCUA may wish to include a target date as a best practice, rather than a requirement.

21. Should part 715 require credit unions to notify NCUA in writing when they enter into an engagement with an auditor, and/or when an engagement ceases by reason of the auditor's dismissal or resignation? If so in cases of dismissal or resignation, should the credit union be required to include reasons for the dismissal or resignation?

Yes, FDICIA, in § 363.4, *Filing and notice requirements*, requires financial institutions to notify the FDIC in writing when the aforementioned events occur, and to explain in writing the reason for dismissal or resignation as follows:

> (d) Notice of engagement or change of accountants. Each insured depository institution shall provide, within 15 days after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the

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> independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.

We believe that part 715 should contain a parallel requirement.

22. NCUA recently joined in the final Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 FR 6847 (Feb. 9, 2006). Should credit Union Supervisory Committees be prohibited by regulation from executing engagement letters that contain language limiting various forms of auditor liability to the credit union? Should Supervisory Committees be prohibited from waiving the auditor's punitive damages liability?

In response to the FFIEC proposal, the AICPA's Professional Ethics Executive Committee (PEEC) stated:

> The AICPA has preliminarily concluded that while certain provisions in an engagement letter limiting the auditor's liability may adversely affect the auditor's independence or objectivity, others would not. The AICPA is not convinced that the use of such provisions increases the risk that the auditor's performance will not comply with professional standards, since auditors must comply with all professional standards, including specific performance standards under generally accepted auditing standards, regardless of whether indemnification or limitation of liability provisions are included in an engagement letter. A failure to comply with such standards would result in a violation of AICPA Rule 202 – *Compliance With Standards,* as well as their own state's licensing requirements.

Supervisory Committees should not be prohibited from waiving the auditor's punitive damages liability. Limiting the auditor's liability to the client for *punitive* damage claims does not impair independence or objectivity, provided the auditor remains liable for *actual* damages —that is, the auditor remains exposed to clients, lenders, shareholders, and other non-clients for damages for any actual harm caused. Actual damages in accountant malpractice or securities law cases can be significant –often hundreds of times (or more), the fees generated in connection with the engagement. The possibility that actual damages might be awarded against an auditor in favor of clients and/or non-clients serves as a significant, real and sufficient deterrent against an auditor's wrongful conduct and adequately mitigates the threats to an auditor's independence and objectivity. In addition, by definition, a limitation on punitive damages can have no affect on the safety and soundness of the financial institution. Punitive damages are defined as damages in excess of all the actual damages and are awarded to punish the wrongdoer in particular circumstances. Since the credit union can recover all of its actual damages, its safety and soundness is secured. Thus, we believe that exclusion of punitive damage liability *to the client* should not be viewed as impairing independence or objectivity.

The AICPA appreciates the opportunity to respond to the NCUA's questions. We would be pleased to discuss our comments with you. If you have any questions, please contact Myrna Parker at 202-434-9241.

Very truly yours,

Carol H. Larson

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